COUNCIL RECOMMENDATION

of 11 July 2017

on the 2017 National Reform Programme of Cyprus and delivering a Council opinion on the 2017 Stability Programme of Cyprus

(2017/C 261/12)

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty on the Functioning of the European Union, and in particular Articles 121(2) and 148(4) thereof,

Having regard to Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies ([1]), and in particular Article 5(2) thereof,

Having regard to Regulation (EU) No 1176/2011 of the European Parliament and of the Council of 16 November 2011 on the prevention and correction of macroeconomic imbalances ([2]), and in particular Article 6(1) thereof,

Having regard to the recommendation of the European Commission,

Having regard to the resolutions of the European Parliament,

Having regard to the conclusions of the European Council,

Having regard to the opinion of the Employment Committee,

Having regard to the opinion of the Economic and Financial Committee,

Having regard to the opinion of the Social Protection Committee,

Having regard to the opinion of the Economic Policy Committee,

Whereas:

(1) On 16 November 2016, the Commission adopted the Annual Growth Survey, marking the start of the 2017 European Semester for economic policy coordination. The priorities of the Annual Growth Survey were endorsed by the European Council on 9-10 March 2017. On 16 November 2016, on the basis of Regulation (EU) No 1176/2011, the Commission adopted the Alert Mechanism Report, in which it identified Cyprus as one of the Member States for which an in-depth review would be carried out. On the same date, the Commission also adopted a recommendation for a Council Recommendation on the economic policy of the euro area, which was endorsed by the European Council on 9-10 March 2017. On 21 March 2017, the Council adopted the Recommendation on the economic policy of the euro area ('Recommendation for the euro area') ([3]).

(2) As a Member State whose currency is the euro and in view of the close interlinkages between the economies in the economic and monetary union, Cyprus should ensure the full and timely implementation of the Recommendation for the euro area, as reflected in recommendations (1) to (5) below.

(3) The 2017 country report for Cyprus was published on 22 February 2017. It assessed Cyprus's progress in addressing the country-specific recommendations adopted by the Council on 12 July 2016, the follow-up given to the country-specific recommendations adopted in previous years and Cyprus's progress towards its national Europe 2020 targets. It also included an in-depth review under Article 5 of Regulation (EU) No 1176/2011, the results of which were also published on 22 February 2017. The Commission's analysis led it to conclude that Cyprus is experiencing excessive macroeconomic imbalances. In particular, it is essential that it tackles the large stock of imbalances in the form of private, public and external debt overhang, and the high level of non-performing loans.

([1]) OJ L 209, 2.8.1997, p. 1.
([2]) OJ L 306, 23.11.2011, p. 25.
([3]) OJ C 92, 24.3.2017, p. 1.

(4) Cyprus submitted its 2017 Stability Programme on 27 April 2017 and its 2017 National Reform Programme on 28 April 2017. In order to take account of their interlinkages, the two programmes have been assessed at the same time. Cyprus's National Reform Programme includes commitments both for the short and the medium term. In particular, it includes measures to reduce private-sector indebtedness, improve the business environment, facilitate access to finance and overhaul the healthcare sector, and commits to reforms of the public sector and the justice system. The National Reform Programme also covers the challenges identified in the 2017 country report and the Recommendation for the euro area, including the need to relaunch investment and ensure the sustainability of public finances. If fully implemented within the indicated timelines, these measures would help address Cyprus's macroeconomic imbalances and country-specific recommendations. Based on the assessment of Cyprus's policy commitments, the Commission confirms its previous assessment that at this stage no further steps are warranted in the framework of the macroeconomic imbalance procedure provided for in Regulation (EU) No 1176/2011 and Regulation (EU) No 1174/2011 of the European Parliament and of the Council ([1]). The implementation of the policy reform agenda will be followed closely by means of specific monitoring.

(5) Relevant country-specific recommendations have been addressed in the programming of the European Structural and Investment Funds (ESI Funds) for the 2014-2020 period. As provided for in Article 23 of Regulation (EU) No 1303/2013 of the European Parliament and of the Council ([2]), where it is necessary to support the implementation of relevant Council recommendations, the Commission may request a Member State to review and propose amendments to its Partnership Agreement and relevant programmes. The Commission has provided further details on how it would make use of that provision in guidelines on the application of the measures linking effectiveness of the ESI Funds to sound economic governance.

(6) Cyprus is currently in the preventive arm of the Stability and Growth Pact and subject to the debt rule. In its 2017 Stability Programme, the Government plans a budgetary surplus in headline terms over 2016-2020 (headline balance around 0,4 % of GDP over the programme period). The medium-term budgetary objective, set at a balanced budgetary position in structural terms, is planned to be reached in 2017. The recalculated ([3]) structural balance is projected to steadily move away from the medium-term objective in the following years, which is not in line with the requirements of the preventive arm of the Stability and Growth Pact. The general government debt-to-GDP ratio is expected to have reached 107,8 % in 2016 and to decline to 99,7 % in 2018 and further to 88,8 % by 2020. The macroeconomic scenario underpinning those budgetary projections is plausible. The risks associated with the macroeconomic assumptions presented in the Stability Programme are to the downside, mainly linked to the high stock of non-performing loans and a possible deterioration of the external environment.

(7) On 12 July 2016, following the correction of the excessive deficit, the Council recommended Cyprus to respect the medium-term budgetary objective in 2016 and in 2017. Based on the Commission 2017 spring forecast, Cyprus is compliant with that requirement in 2017 following an overall assessment. For 2018, Cyprus is recommended to remain at the medium-term budgetary objective. Based on the Commission 2017 spring forecast, this is consistent with a maximum nominal growth rate of net primary government expenditure ([4]) of 0,3 %, corresponding to a structural adjustment of 0,2 % of GDP. Under unchanged policies, Cyprus would be at risk of some deviation from that requirement in 2018 following an overall assessment. Cyprus is forecast to comply with the debt rule in 2017 and 2018. Overall, the Council is of the opinion that Cyprus needs to stand ready to take further measures to ensure compliance in 2018.

([1]) Regulation (EU) No 1174/2011 of the European Parliament and of the Council of 16 November 2011 on enforcement measures to correct excessive macroeconomic imbalances in the euro area (OJ L 306, 23.11.2011, p. 8).

([2]) Regulation (EU) No 1303/2013 of the European Parliament and of the Council of 17 December 2013 laying down common provisions on the European Regional Development Fund, the European Social Fund, the Cohesion Fund, the European Agricultural Fund for Rural Development and the European Maritime and Fisheries Fund and laying down general provisions on the European Regional Development Fund, the European Social Fund, the Cohesion Fund and the European Maritime and Fisheries Fund and repealing Council Regulation (EC) No 1083/2006 (OJ L 347, 20.12.2013, p. 320).

([3]) Cyclically-adjusted balance net of one-off and temporary measures, recalculated by the Commission using the commonly agreed methodology.

([4]) Net government expenditure comprises total government expenditure excluding interest expenditure, expenditure on Union programmes fully matched by Union funds revenue and non-discretionary changes in unemployment benefit expenditure. Nationally financed gross fixed capital formation is smoothed over a 4-year period. Discretionary revenue measures or revenue increases mandated by law are factored in. One-off measures on both the revenue and expenditure sides are netted out.

(8) Public debt is on a downward trajectory but its sustainability remains subject to risks. A number of recent fiscal measures as well as delays in the implementation of key structural reforms are expected to lead to a deterioration in the structural balance and risk reducing the scope for growth-enhancing public investments.

(9) The Cypriot public sector has one of the euro area's highest wage bills (as a percentage of GDP) and remains characterised by inefficiencies. Under the macroeconomic adjustment programme, a series of reforms aiming to address this issue were designed and agreed with social partners. These included the introduction of a binding permanent mechanism limiting wage growth for public employees and a comprehensive reform of the public administration. However, with the exception of the recently adopted reform law on mobility of public employees, the adoption of these legislative reforms is facing obstacles, in particular after a negative vote by the House of Representatives in December 2016. Pending adoption in its binding form, the mechanism limiting growth of public-sector wages is being implemented under collective bargaining agreements and is applicable until 2018.

(10) Some reforms have been undertaken to tackle corruption. Recent developments include reforms to professionalise public procurement at local level, and a political party funding law enacted in December 2015. A constitutional amendment enabling asset disclosure for public officials was adopted in 2016. However, the Coordinating Body against Corruption is not adequately staffed, and weaknesses in the disciplinary regime for public servants remain unaddressed.

(11) Cyprus has been taking measures to reinforce its judicial system but continues to face serious challenges as regards the efficiency thereof. Inefficient court procedures and limited capacity lead to significant delays in processing court cases. This in turn undermines the business environment and, in particular, the functioning of the new foreclosure and insolvency frameworks. The latter have been introduced to help reduce unviable private debt, providing incentives to banks and debtors to agree on restructuring solutions. However, the effectiveness of these tools is impaired by a number of factors, including the aforementioned inefficiencies in the court system, weak administrative capacity and a low level of awareness of the procedures among debtors. Backlogs and delays with issuing and transferring title deeds also remain significant. These contribute to undermining debt reduction efforts and weigh on the recovery of the housing market.

(12) The level of non-performing loans is declining but remains very high, hampering the proper functioning of the banking sector and impacting credit supply to the real economy. Banks underperform the loan restructuring targets agreed with the Central Bank of Cyprus, pointing to the need to broaden the targeting system and make it more efficient and binding, in particular by setting ambitious targets for the reduction of non-performing loans, consistent with banks' reduction strategies for non-performing loans. Re-default rates remain high, exposing potential deficiencies in loan restructuring solutions. Risk provisioning levels increased but remain below the euro-area average, underscoring the need to ensure that collateral valuations are reliable and underpin appropriate risk provisioning. The lack of a secondary market for loans and a loan securitisation framework limit the scope for accelerating deleveraging and moving non-performing loans off banks' balance sheets, which calls for additional regulatory and legislative actions to complete the necessary tools to facilitate banks' balance-sheet management. In addition, the governance and administrative capacity of insurance and pension-fund supervision remain weak, posing risks to financial stability.

(13) Cyprus's economic recovery continues. However, potential growth remains weak, constrained by limited implementation of structural reforms, bottlenecks to investment and shortcomings in the business environment. Growth-enhancing initiatives presented in the action plan for growth are being implemented, albeit rather slowly. A legislative proposal to attract and facilitate strategic investments is still at the draft stage. The Government is working on improving access to finance for medium-sized and small businesses. In order to solve this pressing issue, some new targeted initiatives have been launched, as reported in the National Reform Programme. However, most of these new initiatives on access to finance still remain at a preliminary stage. Privatisation efforts, aimed at attracting productivity-enhancing foreign investments, are facing political opposition and progressing slowly. The reform of the energy sector can also be an important driver for competitiveness, yet there have been delays in its implementation. These concern, in particular, the unbundling of the Electricity Authority of Cyprus and the establishment of the new electricity market, which still hinges upon ensuring the effective independence of the transmission system operator.

(14) Unemployment is decreasing but remains high, especially among young people and the long-term unemployed. Plans to increase the numbers of counsellors in public employment services and improve their specialisation have not yet been implemented. Moreover, their recruitment is likely to occur on temporary contracts, therefore not addressing the challenge in structural terms. As a consequence, there is still insufficient capacity to meet the needs of jobseekers, especially those having more difficulties to integrate in the labour market, and to put in place outreach measures for their activation. The impact of active labour market programmes and income support schemes continues to be constrained by limited quality assessment and follow-up measures.

(15) Cyprus maintains a level of spending in education that is above the Union average. However, educational outcomes are low and have even declined compared to previous years. According to the 2015 results of the Programme for International Student Assessment, Cyprus ranks among the lowest in the Union on the level of basic skills in mathematics, science and reading. While recently introduced remedial measures such as a better system for appointing teachers and a modernisation of school curricula are first steps in the right direction, further action to complete planned reforms, including of teachers' evaluation, could significantly contribute to improving the situation.

(16) Skills mismatches in the labour market are still largely unaddressed, affecting prospects for long-term sustainable growth. Participation levels are low in upper-secondary vocational education and training and the labour market relevance of higher education is weak, resulting in a high share of tertiary graduates working in occupations that do not necessarily require a tertiary degree.

(17) The Cypriot healthcare sector remains characterised by a lack of universal coverage and various levels of inefficiency. This limits access to adequate and effective care. Legislation aiming to create a national health system and provide public hospitals with greater autonomy is key to improving the capacity and cost-effectiveness of the healthcare sector but is still pending parliamentary adoption.

(18) In the context of the 2017 European Semester, the Commission has carried out a comprehensive analysis of Cyprus's economic policy and published it in the 2017 country report. It has also assessed the 2017 Stability Programme, the 2017 National Reform Programme and the follow-up given to the recommendations addressed to Cyprus in previous years. It has taken into account not only their relevance for sustainable fiscal and socioeconomic policy in Cyprus, but also their compliance with Union rules and guidance, given the need to strengthen the Union's overall economic governance by providing Union-level input into future national decisions.

(19) In the light of this assessment, the Council has examined the 2017 Stability Programme and its opinion ([1]) is reflected in particular in recommendation (1) below.

(20) In the light of the Commission's in-depth review and this assessment, the Council has examined the 2017 National Reform Programme and the 2017 Stability Programme. Its recommendations made under Article 6 of Regulation (EU) No 1176/2011 are reflected in recommendations (1) to (4) below,

HEREBY RECOMMENDS that Cyprus take action in 2017 and 2018 to:

(1) Pursue its fiscal policy in line with the requirements of the preventive arm of the Stability and Growth Pact, which entails remaining at its medium-term budgetary objective in 2018. Use windfall gains to accelerate the reduction of the general government debt ratio. By the end of 2017, adopt key legislative reforms aiming to improve efficiency in the public sector, in particular on the functioning of public administration, governance of state-owned entities and local governments.

([1]) Under Article 5(2) of Regulation (EC) No 1466/97.

(2) Increase the efficiency of the judicial system by modernising civil procedures, implementing appropriate information systems and increasing the specialisation of courts. Take additional measures to eliminate impediments to the full implementation of the insolvency and foreclosure frameworks, and to ensure reliable and swift systems for the issuance of title deeds and the transfer of immovable property rights.

(3) Accelerate the reduction of non-performing loans by setting related quantitative and time-bound targets for banks and ensuring accurate valuation of collateral for provisioning purposes. Create the conditions for a functional secondary market for non-performing loans. Integrate and strengthen the supervision of insurance companies and pension funds.

(4) Accelerate the implementation of the action plan for growth, focusing in particular on fast-tracking strategic investments and improving access to finance, and, by the end of 2017, resume the implementation of the privatisation plan. Take decisive steps towards the ownership unbundling of the Electricity Authority of Cyprus and, in particular, proceed with the functional and accounting unbundling by the end of 2017.

(5) Speed up reforms aimed at increasing the capacity of public employment services and improving the quality of active labour market policies delivery. Complete the reform of the education system to improve its labour market relevance and performance, including teachers' evaluation. By the end of 2017, adopt legislation for a hospital reform and universal healthcare coverage.

Done at Brussels, 11 July 2017.

For the Council

The President

T. TÕNISTE